REME COURT, U. S.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 1186

JEROME MATUSOW,

Petitioner,

—against—

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on December 23, 1968.

Citations to Opinions Below

The opinion of the United States District Court, Honorable Sylvester J. Ryan, U. S. D. J. (R. 1472),* is reported at 259 F. Supp. 99. The opinion of the United States Court of Appeals for the Second Circuit, printed in Appendix B,** pages B. 1 et seq. is not yet reported.

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* References to "(R.)" are to the Record in the Court of Appeals.

** References to Appendixes "(A.) (B.) (C.)" are references to the Appendixes filed by the Petitioner, Frederick J. Pagnani.

Jurisdiction

The judgment of the Court of Appeals was entered on December 23, 1968. The jurisdiction of this Court is invoked under 28 U. S. C. Sec. 1254(1).

Questions Presented

1. Whether Petitioner who disclosed to the buyer the fact that he had a beneficial interest in the proceeds of a transaction must, in order to prevent such disclosure from being misleading within the meaning of Rule 10(b)-5, further disclose as a "material fact", the exact nature of his compensation?

2. Whether Petitioner who disclosed to the buyer the identities of all persons having a beneficial interest in the proceeds, must, in order to prevent such disclosure from being misleading within the meaning of Rule 10(b)-5, further disclose as a material fact, the exact allocation of the proceeds among such persons, even when the consideration received by the buyer is admittedly adequate?

3. Was the Petitioner a "finder" in connection with the transactions at issue, and if he was, to what extent is he required to disclose to the buyer the extent of his compensation?

4. Whether Rule 10(b)-5 is now construed to make unlawful the failure of a person in a transaction to disclose to the buyer of property, a joint venture agreement he has with the seller, and whether such a construction of the Rule is invalid under the Fifth Amendment of the

United States Constitution for failure to provide an ascertainable standard of conduct?

5. Whether the Court of Appeals, in issuing an injunction upon a record which the Court itself characterized as disorganized and inadequate, and where the Court also indicated in its opinion that it would condemn such a record in all future cases brought by Respondent, has departed from the accepted and usual course of judicial proceedings?

6. Whether the Court below departed from the accepted and usual course of judicial proceedings in issuing a vague and sweeping injunction against the Petitioner?

Statutes Involved

The statutory provisions involved are Section 10(b) of the Securities Exchange Act of 1934, as amended (15 USC 78j(b)), and Rule 10(b)-5 (17 C. F. R. 240.10b-5) promulgated therein.

Statement

The Complaint was filed on or about June 16, 1966 (R. 1). The jurisdiction of the District Court was invoked under Section 27 of the Securities Exchange Act of 1934, as amended, 15 U. S. C. 78aa.

This action involves the acquisition or attempted acquisition of Great American Industries, Inc. (hereinafter referred to as "GAI") of mining interests in California, Arizona and Nevada (B. 4). Counts Two through Five of Respondent's complaint made no charges against Peti-

tioner, Jerome Matusow ("Petitioner" herein) (R. 15-16). Count One of the complaint alleges that known to certain specified individual defendants but unknown to GAI and its stockholders, Petitioner received or was to receive stock in connection with the proposed acquisition by GAI of the Arizona, Nevada and California properties, although, according to Respondent, Petitioner contributed no property or services of any economic value other than the services allegedly rendered as a "finder" (R. 4-14). Count One further alleged that Petitioner took steps to conceal from GAI and its stockholders the original arrangements relative to the Nevada transaction by entering into new arrangements (R. 12). Petitioner denied generally the material allegations of the complaint and filed an affidavit responding to the charges against him (R. 1190-1192; 1441-1448).

Petitioner did not have anything to do with any press releases or 8-K reports concerning the Arizona and Nevada properties for which certain corporate defendants were held liable.

On March 5, 1966, the Petitioner met a William Thomas Beard ("Beard") who owned all the stock of Basin Mining Co., Inc., a mining company in Arizona (R. 1442). A joint venture agreement was entered into with Beard, Petitioner and his attorney, Frederick J. Pagnani ("Pagnani") whereby Petitioner obtained a ⅔ interest in Basin Mining Co., Inc. ("Basin") in exchange for services to be rendered (R. 1443; 1449-1450).

Petitioner then negotiated the sale of Beard's Arizona property to GAI (R. 1444).

The transaction involved a contract between Beard and GAI for the sale by Beard to GAI of the stock of Basin in return for stock of GAI (R. 1444, 1451; 1453). Beard's agreement with GAI expressly stated, in Paragraphs First and Second, that persons in addition to Mr. Beard, not more than ten in number, had a beneficial interest in the stock of the company owning the properties (R. 1453-1454). It is this transaction alone for which the Court below issued an injunction against Petitioner (B. 18). Petitioner asserted in his affidavit that he told Marren, Financial Vice President of GAI, that Petitioner and Pagnani had an interest in the transaction (R. 1445).

The Nevada properties came to the attention of GAI in April of 1966 when Petitioner telephoned Mack, the GAI Chairman in New York, and told him of the availability of the property, and asked whether he was interested in acquiring it for GAI (R. 1446).

Mack went to Nevada and negotiated for the acquisition of the property. The contract dated April 22, 1966, provided that 134,000 shares were to be issued to Petitioner, and 33,000 shares apiece to Pagnani and Beard in accordance with their four-sixths and one-sixth respective interests in the proceeds of the joint venture (B. 13). The additional shares were being received by Petitioner also because of his guarantee of $250,000 to one of the sellers, Crofoot (R. 1446). The closing did not take place because of the suspension of trading in the stock of GAI, and also because litigation arose relative to the property (R. 1410). Subsequently, the contract was renegotiated to provide for indemnifications by certain parties to GAI with respect to the litigation, the assumption by certain parties of certain exploration costs and the issue of a total of

45,000 shares to Petitioner, Beard and Pagnani, which were to be divided equally between them since Beard and Petitioner had renegotiated their joint venture, and because GAI had taken over the guarantee to Crofoot (B. 13; R. 1446). The shares to be received by each is expressly stated in the contract (R. 1410-13). It is this renegotiation which the Commission called an attempt to "conceal" the original arrangement (R. 12, Complaint).

There is no evidence in the record, and nothing in either the decision of the District Court or that of the Court of Appeals, controverting in any material respect Petitioner's statements in his affidavit as to the manner in which he became associated with the Arizona and Nevada transactions, or the role he played.

The opinion of Judge Ryan in the District Court, insofar as it relates to the charges concerning Petitioner, made the following findings: (1) The officers of GAI probably knew that others besides Beard were to receive some of the shares being issued by GAI in the Arizona transaction (R. 1487-89, Op.). (2) "Beard, Pagnani and [Petitioner] had a joint venture agreement providing for their share in mining properties owned or controlled by Beard; [Petitioner] to contribute sales services and Pagnani his legal services to a ratio of 4/6 for [Petitioner] and 1/6 each to the other two, Beard and Pagnani" (R. 1489, Op.). (3) The officers of GAI "knew Pagnani as Beard's attorney. They undoubtedly knew that [Petitioner] and Pagnani were to be compensated by Beard" (R. 1489, Op.). (4) "After an inspection by Mack and his mining expert Behre [of the Nevada property], and a favorable report on it recommending exploratory drilling, Pagnani, under his joint venture agreement with Beard and [Petitioner],

drew the sales contract [for the Nevada property] between GAI, as purchaser, and Pacific Sulphur Company, as seller." The contract provided for the issue "of 200,000 shares to [Petitioner] and Pagnani and Beard (4/6, 1/6 and 1/6 according to their agreement)" (R. 1491, 1492, Op.). (5) "The closing scheduled for April 20, 1966 never took place because of the trading suspension and also because in the meantime a lawsuit had been started by one claiming that it had a contract of purchase with Crofoot. After further negotiations, on June 3, 1966, a new agreement was drawn providing for the same price of 300,000 shares of GAI stock, but to be differently apportioned—[Petitioner], Beard and Pagnani to receive 15,000 shares each, and the balance to go to Crofoot to increase its allocation to 44,232 shares and Canyon and Commonwealth to 105,384 shares each" (R. 1492, Op.). (6) "The charge that the Nevada agreement was redrawn in order to conceal the fraud on GAI falls by reason of our finding that there was no fraud and also of its own weight. If defendants were out to fraudulently induce GAI to issue its shares, as is charged, a change in the reallocation of the same number of shares would still be a rather obvious fraud. Perhaps the investigation did make defendants take a harder look at their bargain, but this would not be evidence of consciousness of guilt. Besides, the Commission has not disputed the reasons advanced by all defendants for the revision of this agreement" (R. 1496, Op.).

The Court also found that Respondent had failed to establish that the facts allegedly concealed were material facts which would have influenced GAI in its decision to issue the stock. On the basis of the foregoing, the District

Court refused to issue a temporary injunction against Petitioner.

The Court of Appeals reversed and issued an injunction of uncertain scope and unspecified duration against Petitioner. The Court found that Petitioner had been present at the closing of the Arizona property; that purchaser's Vice-President had asked Beard who else had a beneficial interest in the stock of the seller; and that Beard and Petitioner had disclosed the names and the fact of their beneficial interest, but not their exact shares. The Court found that Petitioner did not come forward at that point and explain the exact nature of his financial relationship, or the financial relationship of others, and that failure to do so was common law fraud resulting in a violation of 10b-5 and that an injunction was proper (B. 17-18).

Reasons for Granting the Writ

1. The holding of the Court of Appeals that the fact a person is entitled to four-sixths of the sale proceeds under a pre-existing contingent fee agreement with the owner of property is a material fact which must be disclosed to a purchaser—even when the adequacy of the consideration received by said purchaser is unquestioned—raises an important issue hitherto undecided by this Court which should be resolved by it in order to remove the cloud of uncertainty which now hangs over every acquisition for stock of the acquiring company.

The Court of Appeals acknowledged that its view of materiality has undergone revision since *Securities and Exchange Commission* v. *R. A. Holman & Co.*, 366 F. 2d

456, 459 (2d Cir. 1966), and has been "further developed" in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968). The instant case expands the concept of materiality still further, and in a manner which is internally inconsistent. The trial court found that since Respondent conceded that it was not questioning the value of the properties acquired in exchange for the shares issued, the court had to assume that the consideration was adequate—irrespective of who was to receive it. The failure to disclose the allocation was *not* a failure to disclose the true purchase price demanded by sellers. The true purchase price of the property is the material fact involved, not how that price will later be allocated. The trial court, it is submitted, was entirely correct. And at one point the majority of the Court of Appeals recognizes this fact, saying that the trial judge may still have been within the bonds of allowable discretion in holding that no sufficient case for issuing an injunction had been made if the episode of the distribution of the shares stood alone, citing *Securities and Exchange Com'n* v. *Texas Gulf Sulphur Co., supra,* but that coupled with consideration of the misleading reports and releases there were sufficient grounds to issue an injunction against the corporate defendants. Yet all Petitioner is charged with is failure to disclose the distribution of the shares, so that upon the Court of Appeals' own holding with reference to materiality the District Court should have been upheld as to Petitioner.

How could Petitioner possibly know that the Court would find that his financial relationship to seller was material?

The decision below presents an issue not previously decided by this Court, and one which should be resolved in order to establish a definition of what is material with regard to a sellers plan for allocation of the proceeds of sale in future cases involving acquisitions for stock.

2. The position taken by the Court of Appeals, that Petitioner committed common-law fraud by not disclosing his exact financial relationship to seller when questioned by buyer, is plainly wrong on the facts of the action; it is in conflict with a decision of the Third Circuit Court of Appeals in *First Trust & Savings Bank* v. *Fidelity-Philadelphia Trust Co.*, 214 F. 2d 320 (3d Cir. 1954); and it presents the likelihood of chaos in the future regulation of the Securities Laws.

Briefly, the Court below found that Petitioner acquiesced in a partial statement made by Beard and that he failed to disclose additional facts. When an officer of GAI asked who besides Beard had a beneficial interest in the stock GAI was buying, Petitioner replied that he and Pagnani did (B. 17). Petitioner never misled anyone. He was called upon to disclose the *fact* of his interest, not the *extent* of it. He did so disclose, placing purchaser on notice as to his interest. The Court below has held that buyer need inquire no further, because it refused to impose liability on the corporate defendant for the Arizona transaction. If buyer need go no further, seller and Petitioner should not have to do so either.

The Third Circuit has held in *First Trust & Savings Bank* v. *Fidelity-Philadelphia Trust Co.*, 214 F. 2d 320 (3rd Cir. 1954) that similar facts to those stated above do not constitute common law fraud. In that case plaintiff

First Trust sued defendant bank for loss when it was discovered that certain liquor warehouse certificates held for security on notes purchased and deposited for safe-keeping with defendant and forwarded by defendant to plaintiff were spurious. The credit manager of defendant had responded by letter to an inquiry by plaintiff concerning the credit of the maker of the notes and certificates found to be spurious. The Third Circuit found in discussing this letter:

> "There is more to be said about the letter however. It went on to say that PAC's account was handled in a satisfactory way and gave an explicit statement about an average five-figure balance. This five-figure statement was true but it was also found as a fact that twelve times in the two months before the letter was written, PAC had had overdrafts amounting to sums from several hundred dollars. We do not go with the argument that when a man says something that is literally true he has told the truth even though he does not tell the other things which would qualify the statement made. 'To tell half a truth only is to conceal the other half.' But the saving grace of the letter is the last sentence. The defendant's credit manager said: 'A condensed balance sheet exhibited to us last year indicates that the net worth of the Philadelphia Acceptance Corporation is limited and is substantially less than outstanding obligations.' That, we think, is enough. The sum total impression from the letter is truthful and certainly gives warning to one who is prospectively going to extend credit to the concern inquired about." (Appendix C. 9-10)

The instant situation is similar in all material respects. Petitioner was truthful in the answer he gave and certainly gave warning to GAI, the purchaser, of the fact that others had a beneficial interest in the deal. The finding in *First Trust* that there was no common law fraud is directly contrary to the result in this action.

The decision below, if left undisturbed, will wreak havoc with the affairs of the business community and also with regulation of the securities laws. It will do away completely with the selling "undisclosed principal" who is to receive stock of the purchaser, because the agent or attorney for said principal will have to disclose the nature and interest of his principal or principals or run the risk of violating the majority opinion below. The doubt now cast over such transactions will lead to nothing but confusion in regulating such transactions, and it will be confusion on a grand scale when the number of acquisitions for stock taking place every day is considered. This court should decide the important question raised by the Court of Appeals' expansion of the doctrine of common law fraud as it relates to sellers and their partners, agents and attorneys.

3. Petitioner was not a "finder" but a partner of Beard. The agreement of March 10, 1966 so provided (R. 1449-1450). Was petitioner as a partner required to disclose the extent of his interest? Who is to rule on whether he gave valuable consideration for this interest? GAI or the Respondent should not be able to complain as to the consideration for Petitioner's interest but only Beard. To call Petitioner a finder when the agreement indicates otherwise is to distort the facts in order to wrongfully enjoin Petitioner.

4. It is a fundamental principle of constitutional law that an administrative rule or regulation imposing civil or criminal liability must provide some readily ascertainable standard of conduct so that those subject to the law might determine what they are proscribed from doing. *In Re Ruffalo,* 390 U. S. 544 (1968); *Whitehill* v. *Elkins,* 389 U. S. 54 (1967); *Keyishian* v. *Board of Regents,* 385 U. S. 589 (1967); *Bantam Books, Inc.* v. *Sullivan,* 372 U. S. 58, 71 (1963); *Winters* v. *New York,* 333 U. S. 507 (1948); *Kraus & Bros.* v. *United States,* 327 U. S. 614 (1946); *Lanzetta* v. *New Jersey,* 306 U. S. 451 (1939).

As this Court stated in *Kraus & Bros., Inc.* v. *United States, supra*:

> ". . . The dividing line between unlawful evasion and lawful action cannot be left to conjecture. The elements of evasive conduct should be so clearly expressed by the Administrator that the ordinary person can know in advance how to avoid an unlawful course of action" (327 U. S. at 621-22).

The principle set forth above is plainly applicable to this proceeding, for violation of Rule 10b-5 is clearly punishable by fine and imprisonment. See Section 32(a), 15 U. S. C. §78ff(a).

The holding by the Court of Appeals that Rule 10b-5 applies to conduct on the part of a partner of the seller, when that conduct is not fraudulent, is clearly novel. The standard of conduct which the Court of Appeals has thus read into Rule 10b-5 is not one which a reasonable man could define from either Section 10(b) or Rule 10b-5 and the Court's retroactive application of the standard of conduct it enunciates to petitioner violates his constitutional rights under the Fifth Amendment.

The Rule which it is charged petitioner violated was promulgated in 1942, based on Section 17 of the Securities Act of 1933. Not until the case *Matter of Cady, Roberts & Co.*, 40 S. E. C. 907, did respondent attempt to apply the Rule to undisclosed inside information, absent any misleading statement. Without reliance on any prior decision the Court of Appeals has now enunciated the rule that Petitioner has a duty to disclose the allocation of the consideration received from the owners of stock when the percentage of the consideration to be allocated to other than the named seller exceeds some unspecified amount and some form of inquiry is made by purchaser. No commission, rule or regulation has been cited by respondent in this proceeding as governing expressly the situation presented herein. The Court of Appeals has indicated that they are loath to undertake the task of drawing distinctions according to the importance of the transaction between sellers of property and finders or between finders acting solely for such sellers and those having some special relationship to an issuer. Thus the court below has in fact admitted that they have enunciated no ascertainable standard and, as the concurring opinion of Judge Waterman states, the court is moving on a case by case basis without any attempt to formulate such a standard. Respondent has promulgated no guideline which would indicate to any investor in a future action when he has violated the maxim set forth in the opinion of the court below. It cannot reasonably be said that Rule 10b-5, as construed by the court below provides an ascertainable standard of conduct so "the ordinary person can know in advance how to avoid an unlawful course of action." *Kraus & Bros., Inc.* v. *United States, supra* at 621, 622.

5. Clearly, the question presented is of importance in the regulation and administration of the Federal Securities Laws. Indeed, the procedure followed in this action is one frequently employed by respondent to enforce an important provision of the Federal Security Laws, Section 10b of the Securities Exchange Act of 1934, as amended (15 USC 78j(b)) and Rule 10b-5 (17 CFR 240. 10b-5) promulgated thereunder. Respondent proceeds by filing a complaint and an affidavit paraphrasing the complaint and seeks on the basis thereof a temporary and permanent injunction. Often, as was the case in the instant action, respondent paraphrases important exhibits and does not annex them. In its unusual opinion, the Court of Appeals condemned this practice and yet on the basis of so-called evidence resulting therefrom issued an injunction against petitioner. The court in its opinion stated that the practice was defective and had been condemned in a case decided before that very court [*Securities and Exchange Commission* v. *Frank,* 388 F. 2d 486, 490-92]. The Court of Appeals even noted that the District Court had complained that the documents were not quoted or presented and, that the District Court had to determine the degree of knowledge possessed by corporate officers—a critical issue in the case—without seeing or hearing those officers. The Court of Appeals also stated that the disorganized record handicapped it in considering the appeal, and went on to say:

> "The District Courts are not to accept the kind of moving affidavit that was offered here; the Commission had sufficient facilities to enable it to present documents in full text."

Since the Court of Appeals enjoined petitioner, the language quoted above could only be regarded as dictum. Furthermore, the language quoted above cannot purport to enjoin District Courts in other Circuits proceeding with decisions based on the affidavit practice of respondent. The whole process of granting the extraordinary remedy of a temporary injunction on the basis of incomplete and inadequate documentation and without hearing witnesses when the issues involved concern the knowledge possessed by those accused of wrongdoing is clearly improper. Furthermore, to enjoin Petitioner on the basis of a practice which the Court interdicts District Courts from following in the future plainly violates Petitioner's right to equal protection of the laws and presents a situation where the Court of Appeals has so far departed from the accepted and usual course of judicial proceedings, as the Court of Appeals itself defines those proceedings in the *very same action*, as to call for an exercise of this Court's power of supervision.

6. The court below has decreed that an injunction be issued against Petitioner. The Court of Appeals did not specify the scope and duration of the injunction, although in the headnote they did refer to the remedy as a temporary injunction. They do not indicate, however, how temporary it is, and it might well be perpetual. The court also declined to state what Petitioner is enjoined from doing, beyond as Justice Moore points out, "violating the law with respect to stating facts or omitting to state facts regarding securities transactions." The Respondent, therefore, is free to use whatever hindsight it chooses in order to threaten Petitioner with contempt proceedings for anything it might be able to imagine. Clearly Petitioner

should have some clearer standard of conduct against which to measure his action.

7. The decision of the Court of Appeals certainly stretches 10(b)-5 beyond the realm of sensibility. As Judge Ryan correctly asserted:

> "If GAI received value for its shares it is difficult to see where the fraud lay since it has not been charged that the identity of those receiving the stock was any part of the consideration or affected the value of the shares. What the seller of the property intended to do or had bound himself to do with them played no part in the transaction" (R. 1486).

The agreement as to the division burdened Beard, not GAI or its stockholders. To hold Petitioner responsible for a common law fraud and a 10(b)-5 violation is certainly contrary to the rules of logic. Judge Moore in his dissenting opinion made the following comments:

> "The purchase price to GAI of this property was 300,000 GAI shares for the selling group. The majority characterize the division of the stock amongst the sellers as a 'peculiar division of the consideration' but query, is a federal court years after the event to dictate what the sellers chose to do with the proceeds of their sale?"
>
> "Neither Matusow nor Pagnani were under a duty to advise GAI stockholders or the public as to their private agreement with Beard or the reasons why Pagnani agreed to perform legal services as an attorney for a one-sixth stock interest in the event stock were received as the result of any future transaction.

* * * * *

"Consider for a moment the consequences of the majority's statement that 'It must be conceded that imposing on sellers of property or finders a duty of full disclosure to a buyer issuing securities in exchange, with a consequent duty on the latter to publicize material facts so disclosed, would increase the protection afforded investors and traders by the securities laws.' Were this the law, or to be the law, no acquisition of property for stock could safely be made. For the buyer to be safe, he would have to obtain from the seller a statement of any and all obligations which the seller might have in connection with the sale, any finder's fees for which he might be liable, a description of the intended distribution of the proceeds and the reasons justifiable at a later date to SEC and federal courts for such distributions. In addition, he would have to refrain from any business transaction involving acquisition of property for stock until he had obtained from the seller the information just mentioned. And he would be forced to discontinue negotiations, no matter how advantageous the deal might be to the stockholders, if the seller refused to disclose his own private affairs by a curt 'None of your business.' In any event, the business wisdom of seller and buyer could always be attacked by the Commission at some future date if its business judgment differed from that of the parties." (B. 44, 45)

* * * * *

"If Matusow were a finder, he certainly was not a finder employed for a fee by GAI. In the only transaction (Nevada) considered by the majority, his involvement was as a participant in the selling group,

i.e., Pacific Sulphur. The injunction against Matusow must be read as an interdict against his being a member of any selling group unless he discloses his interest or his fees to the buyer. In this particular case, Matusow would have had to have disclosed the background of his $250,000 guaranty to Crofoot, the reasons therefor and the negotiations with Crofoot, Commonwealth and Canyon State, which led to the divisions of stock in question." (B. 61)

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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